N. 2903

Docket No. 13608

In the

United States Court of Appeals

For the Ninth Circuit

THE JOHN DANZ CHARITABLE TRUST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent,*

ON PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

F. A. LESOURD,
LITTLE, LESOURD, PALMER & SCOTT,
Attorneys for Petitioner.

1510 Hoge Building,
Seattle 4, Washington.

THE ARGUS PRESS, SEATTLE

Docket No. 13608

In the

United States Court of Appeals

For the Ninth Circuit

THE JOHN DANZ CHARITABLE TRUST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent,*

ON PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

F. A. LESOURD,
LITTLE, LESOURD, PALMER & SCOTT,
Attorneys for Petitioner.

1510 Hoge Building,
Seattle 4, Washington.

THE ARGUS PRESS, SEATTLE

INDEX

CITATIONS

Cases

Cases

Statutes

Statutes

Miscellaneous

Miscellaneous

In the

United States Court of Appeals

For the Ninth Circuit

THE JOHN DANZ CHARITABLE TRUST, *Petitioner*, v. COMMISSIONER OF INTERNAL REVENUE, *Respondent*,	**Docket No. 13608**

ON PETITION FOR REVIEW OF DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

This case involves questions as to the liability of an irrevocable charitable trust to pay income taxes. Appeals from decisions of the Tax Court in two cases, involving the same taxpayer but for different years, consolidated for trial before that court (R. 117), are likewise consolidated for consideration by this Court (R. 145).

OPINION BELOW

The opinion of Judge J. Edgar Murdock is found at R. 118, and is reported in 18 T.C. 454 under the name of *John Danz*. The opinion was not reviewed by the full Tax Court.

JURISDICTION

The jurisdiction of the Tax Court was based on I.R.C. §272. Notice of deficiencies for the years 1943, 1944 and

1945 was mailed to the petitioner on October 14, 1949, and petition for redetermination of the tax was filed with the Tax Court on January 9, 1950. The notice of deficiencies for the years 1946 and 1947 was mailed to the petitioner on March 5, 1951, and petition for redetermination of the tax was filed with the Tax Court on April 9, 1951. (R. 85.)

Jurisdiction of this court is based on I.R.C. §§ 1141 and 1142. The decisions of the Tax Court were entered on August 19, 1952. (R. 130, 131.) Petition for review by this court was filed in the Tax Court on September 11, 1952. (R. 131-133.) Venue in this court is established by I.R.C. §1141, and the fact that the returns of the tax in respect of which the liabilities arise were made to the Collector of Internal Revenue in Tacoma, Washington, within this circuit. (R. 109.)

STATUTES INVOLVED

The statutes involved in this case are set forth in the Appendix, *infra,* pp. 67-70.

QUESTIONS PRESENTED

1. Is an irrevocable trust, all of the corpus and income of which must go to exempt organizations, to be denied income tax exemption under I.R.C. §101(6) for the years 1943 through 1947 because, during those years, it operated temporarily, while attempting to find a lessee, a hotel which was part of a building purchased by the trust as a real estate investment and because, during those years, it operated three small candy shops as a means whereby volunteer services could be devoted to raising money for charity?

The Tax Court denied exemption.

2. Where the trust agreement irrevocably requires all corpus and income of the trust to be paid to exempt organizations, is the trust, in the years 1943 through 1947, to be denied the deduction granted by I.R.C. §162(a) (which provided for deduction of all income paid or permanently set aside for or to be used exclusively for exempt purposes), by reason of the fact that the trust agreement does not require the income to be distributed in the year earned, and the trust did not distribute all of its income each year but invested part of the income and used part of the income to pay off obligations previously incurred in the purchase of investment assets?

The Tax Court denied the deduction.

3. Did the filing by the charitable trust of returns under the provisions of I.R.C. §54(f), (providing for the filing of income tax returns by exempt organizations), for the years 1943, 1944 and 1945, showing the itemized income and disbursements of the trust, commence the running of the Statute of Limitations on assessment of tax contained in I.R.C. §275(a)?

The Tax Court held that the returns did not start the running of the Statute of Limitations.

STATEMENT

This case involves appeals from the decision of the Tax Court in two cases (being Docket Nos. 26404 and 33429 of that court), which were consolidated for trial and decision in the Tax Court and have been consolidated by order of this Court for hearing on appeal. Tax

Court Docket No. 26404 involves income tax imposed on the John Danz Charitable Trust for the calendar years 1943, 1944 and 1945, and Tax Court Docket No. 33429 involves income tax imposed on the same taxpayer for the calendar years 1946 and 1947.

Presented here are solely questions of law arising on the findings of fact of the Tax Court. These findings dealt not only with the two cases now before this Court, but also with certain other related cases wherein the Commissioner sought to tax the income of the John Danz Charitable Trust to the creators of that trust under the doctrine of *Helvering v. Clifford,* and sought to deny deductions to those who had made contributions to the trust. The Tax Court found against the Commissioner in these related cases and no appeal has been taken from those decisions. Since all of the cases were consolidated for trial below, part of the findings of fact are devoted to the issues in these other cases and are not pertinent to this appeal.

In its findings of fact, the Tax Court adopted as a part thereof all of the facts stipulated by the parties. Consequently, that stipulation and its attached exhibits have been designated for the record in this Court along with the findings of fact proper of the Tax Court.

The portions of the findings of fact proper of the Tax Court that are relevant to this appeal are as follows (R. 109-117):

John Danz has been engaged in the business of operating motion picture theatres in Seattle for about forty years. He concluded during the latter part of World War II that different ideologies were causing a great

deal of trouble and even had a tendency to create wars; the country was about ready for some philosophy with some common ground acceptable to everyone based upon science, pragmatism, experience and research that would eliminate all differences of opinion; but to get such an organization started in a large number of communities would require money. He and his wife created a trust on December 31, 1942 for the purpose of making and supplying money for that purpose. They called it "The John Danz Charitable Trust". John hoped to find some organization in the United States with a number of branches which could be helped with the trust funds to grow and educate the people. He did not know of any such organization at the time he created the trust and for that reason, reserved in the trust the right to designate the charitable beneficiaries of the trust.

John and Jessie, as grantors, transferred to the trustees by the trust instrument 900 shares of Sterling Theatres, Inc. common stock. John, William and Fredric Danz were named as trustees in the trust instrument. The trustees were given broad powers over the trust property, including the power to engage in business under various forms, to loan funds of the trust with or without security, to join in enterprises in which the trustees were personally interested provided that they exercised good faith in the interests of the trust estate, and, in investing or speculating, to combine funds of any trusts created by the grantors. The trustees were entitled to receive reasonable compensation for their services but received none during the taxable years. They were not to be personally liable, in the absence

of bad faith, for any losses from proper use of the trust funds. The grantors were not to derive and they have not derived, directly or indirectly, any benefit from the trust property.

John Danz was to have the right during his lifetime and by his will to designate the beneficiary or beneficiaries of the trust and to change, add, or withdraw beneficiaries which were to receive corpus or income of the trust at times and in amounts specified by him. Designations were to be in writing delivered to the trustees. Only a corporation or organization "of a type which is within the exemption from Federal income tax now granted by paragraph 101 of the Internal Revenue Code and in the event such exemption is hereafter restricted, then also within such restrictions" could be designated and the beneficiary also had to be of the type then specified in paragraphs 23(o), 812(d), and 1004(a)(2) of the Internal Revenue Code so that the contribution bequest or gift to such beneficiary would be deductible from income and exempt from estate and gift tax and in the event those classes were further restricted, then the beneficiary had to be within such restrictions. Named adult grandchildren or the trustees were to make similar designations covering any amount remaining in the trust after John's death and not covered by his will.

The trust was irrevocable but could be amended in certain respects by the joint action of William Danz, Fred Danz and Leslie Stusser. The power to amend did not include the power to change the beneficiaries or to make a change which would in any way benefit the grantors or their estates. Additional property could

be added to the trust. Leslie Stusser was to take the place of John Danz as trustee if occasion arose. Any other vacancy was to be filled by an appointment made by the remaining trustees. The trustees were to act through a majority. The trust instrument was to be governed by the laws of Washington.

Leslie Stusser was not related to or employed by any of the Danzes mentioned herein.

No amendments were made in the trust during the taxable years. John, William and Fredric Danz served as trustees of the trust from its inception throughout the taxable years. Books and records were kept for the trust. Title to all of the assets of the trust has been taken in the name of the trustees. Bank accounts were maintained for the trust.

John and Jessie Danz made additional contributions to the trust during the taxable years in cash, in stock of Sterling Theatres, Inc., and in stock of Sterling Theatres Company, Inc. William and Selma Jane Danz and Fredric and Selma Danz made cash contributions to the trust during the taxable years. The total contributions made to the trust during the taxable years, taken at the fair market value of each at the time it was made, amounted to $109,542.00. The stock in Sterling Theatres, Inc. and in Sterling Theatres Company, Inc. held by the trust was a small part of the total outstanding stock of those corporations and played no part in the control or management of those corporations.

John Danz, after the creation of the trust, continued, at his own expense, to search for the type of organiza-

tion which he had in mind in forming the trust, and after several years of travel and search, he decided that there were groups of humanists which came close to what he had in mind. He was instrumental with others in starting such an organization in Seattle beginning in the early part of 1947. It was incorporated as the Humanist Society of Washington. Prior thereto and beginning in September 1946, he had designated "American Humanist Society", an organization which had a number of affiliates in different parts of the United States, as a beneficiary to receive funds of the trust in the total amount of $11,500.00. He was also instrumental, along with others, in starting the Humanist Society of San Francisco and, after the taxable years, in starting the Humanist Society of Los Angeles. The first distribution from the trust to the Humanist Society of Washington was made on March 20, 1947. Thereafter during that year additional large distributions were made to it, to the Humanist Society of San Francisco, and to other charitable organizations.

The trust purchased 600 shares of stock of Midland Steel Products for $17,691.64 in 1943 and sold those shares for a profit of $4,583.62 in 1945. It bought and retained 500 shares of Anaconda Copper in 1945 and 1,500 shares in 1946, and in 1946, 1,000 shares each of Boeing Airplane Company, National Gypsum, and Westinghouse Electric at a total cost of $161,154.25. It also held on December 31, 1947, donated shares of Sterling Theatres, Inc. and Sterling Theatres Company, Inc. which it carried at $56,992.00.

The trust made the following purchases:

	Cost	*Year*
Savoy Hotel Property, including furnishings and fixtures	$166,440.76	1943
Improved real estate Seventh and Pike	95,544.23	1943
Improved real estate Eighth and Pike	42,866.11	1943
Improved real estate Sixth and University	75,104.70	1946
Improved real estate, San Francisco	42,882.35	1947

It held the properties during the remaining taxable years and received rents therefrom, except that it sold the property at Eighth and Pike in 1946 at a profit of $43,740.78. The Savoy Hotel property and the Seventh and Pike properties substantially increased in value during the taxable years. There was a mortgage on the Savoy Hotel building in the amount of about $68,000.00 at the end of 1943. It was reduced $21,676.00 during 1944, but by the end of 1945, it had been increased to about $91,000.00. Thereafter, it was gradually reduced until it amounted to $45,739.74 at the end of 1947. There was a mortgage on the Seventh and Pike property which amounted to $44,860.04 at the end of 1943. It had been reduced to $19,689.04 by the end of 1945 and was paid off in 1946. There was a mortgage on the Sixth and University property which amounted to $54,582.22 at the end of 1946. It had been reduced to about $45,000.00 at the end of 1947.

The trust borrowed money from John Danz and from Sterling Theatres, Inc. at 3 per cent during the taxable

years. John had to borrow money at interest rates in excess of 3 per cent to make the loans to the trust. The loans payable of the trust at the end of 1943 amounted to $138,321.06. They were about $4,000.00 less at the end of 1944 and amounted to about $1,800.00 at the end of 1945. They amounted to $109,000.00 at the end of 1946 and to $89,500.00 at the end of 1947.

The trust purchased a retail candy shop on September 10, 1943 for $1,514.75, another on September 22, 1943 for $875.00, and a third on January 31, 1944 for $1,500.00. It operated each shop after the purchase throughout the taxable years but at some undisclosed time thereafter ceased operating them. Each candy shop was adjacent to a theatre owned or managed by Sterling Theatres, Inc. Jessie Danz managed the three candy shops without pay because she wanted to make a contribution in that way to the acquisition of funds for the charitable trust.

The net worth of the trust, as shown on its balance sheets, increased from $65,862.62 at the end of 1943 to $448,420.09 at the end of 1947.

The average of the annual gross receipts from the Savoy Hotel for the taxable years was about $141,-000.00, the operating expenses about $96,400.00, and the net income about $44,600.00. The trust had additional income from rentals during the taxable years ranging from $2,270.00 in 1943 to $12,564.50 in 1945. The total sales of the candy shops during the taxable years were $329,233.95, the net sales $158,689.10, expenses $106,-435.75, and the net profits from the operation, including a small amount of income from telephones, were $52,-

650.44. Dividends received by the trust during the taxable years amounted to $23,458.10. The total net income of the trust for the taxable years, including profits on sales, was $404,526.29.

The trust made no distributions in 1943. Thereafter, it made distributions to a number of organizations, exempt from tax under §101, of the types described in §§23(o), 812(d), and 1004(a)(2) of the Internal Revenue Code. The total of those charitable contributions was $65,637.54, of which about two-thirds was contributed in 1947.

The Humanist Society of Washington occupied a large portion of the Sixth and University building rent-free from the time of the inception of that organization. The trust received rent from some other space in that building. The building in San Francisco was occupied rent-free by the Humanist Society of San Francisco.

The intention of the trustees in purchasing the Savoy Hotel property was to operate it only until the personal property could be sold and the real property leased to a hotel operator. Efforts were made to find such a lessee but no satisfactory arrangement was made until January 1, 1948. The hotel, at the time it was purchased by the trust, was being operated by a real estate company in Seattle, and that company continued to operate the property for the trust under an oral agreement during the taxable years and until January 1, 1948 when the furnishings were sold for $60,000.00 and the real estate was leased to a hotel operator.

The following facts contained in the Stipulation

which was adopted by the Tax Court in its findings of fact are relevant to this appeal:

On September 19, 1946, petitioner filed with the Collector of Internal Revenue an exemption affidavit on Form 1023 together with returns on Form 990 for the calendar years 1943, 1944 and 1945 (R. 83; Joint Exs. 2A, 3C and 4D). The returns on Form 990 stated that they were required under I.R.C. §54(f) (Joint Exs. 2A, 3C and 4D). On these returns, petitioner set forth in detail for each year the amounts of contributions received, dividends and interest received, rents received, gross receipts from business activities (setting forth separately the gross receipts from the Savoy Hotel and from the candy stores), cost of goods sold, compensation paid, interest paid, taxes paid, other operating, administrative and overhead expenses paid, and contributions paid (R. 84-85; Joint Exs. 2B, 3C and 4D).

On July 3, 1947, pursuant to a ruling by the Commissioner of Internal Revenue that petitioner was not exempt, the Collector of Internal Revenue wrote to petitioner demanding the filing of income tax returns on Form 1041. On July 28, 1947, income tax returns on Form 1041 were filed by petitioner for the calendar years 1943, 1944, 1945 and 1946 (R. 84; Joint Exs. 6F, 7J, 8H and 9I). The returns were accompanied by a letter from Trustee William Danz stating that the returns were being filed in accordance with the Collector's request but that the Trustees did not agree that returns should be filed and believed that the Charitable Trust was exempt from tax (R. 84).

In each of the returns on Form 1041, petitioner

showed the income and expenses, took deductions for contributions paid during the year, and took a deduction in the amount of the balance of the income as constituting income which pursuant to the terms of the trust agreement, was permanently held and set aside for exempt purposes under I.R.C. §162(a) (R. 84-85; Joint Exs. 6F, 7J, 8H and 9I).

Petitioner has not engaged in any activities to influence legislation or carry on propaganda (R. 93).

On June 4, 1952, the Tax Court handed down its opinion to the effect that petitioner was not exempt under I.R.C. §101(6); that petitioner was taxable as a trust and not as an association; that petitioner was not entitled to a deduction under I.R.C. §162(a) for income not distributed during the taxable year; and that the returns on Form 990 for the calendar years 1943, 1944 and 1945 did not start the running of the Statute of Limitations (R. 128). Pursuant to this opinion, the Tax Court entered its decision on August 19, 1952 in Docket No. 26404 finding deficiencies in income tax against petitioner as follows:

1943	$11,050.71
1944	50,955.97
1945	56,848.76

On the same date, decision was entered in Docket No. 33429 finding deficiencies in income tax as follows:

1946	$38,837.34
1947	7,974.69

Also, the decision found a penalty under I.R.C. §291(a) in the amount of $797.47 for 1947. (R. 130; 131.)

SPECIFICATIONS OF ERROR

Petitioner relies upon the following errors of the Court below:

1. The Tax Court erred in deciding that on its findings of fact petitioner was not exempt from Federal income tax under I.R.C. §101(6).

2. The Tax Court erred in deciding that on its findings of fact petitioner was not entitled to a deduction in computing its Federal income taxes of all of its income under I.R.C. §162(a).

3. The Tax Court erred in deciding that on its findings of fact the proposed Federal income tax deficiencies against petitioner for the years 1943, 1944 and 1945 were not barred by the Statute of Limitations set forth in I.R.C. §275(a).

4. The Tax Court erred in failing to enter a decision that there were no deficiencies in Federal income taxes due from petitioner for the years 1943, 1944, 1945, 1946 and 1947.

SUMMARY OF ARGUMENT

Petitioner was exempt from tax under I.R.C. §101(6) even though it had income from the operation of a hotel and small candy shops. The generally accepted rule is that exemption under this section is determined by the destination of the income, not the source. While this court has made no definite pronouncement on this point, nevertheless, in *Squire v. Students Book Corp.,* 191 F.(2d) 1018 (C.A. 9th) this court indicates that it will follow this general rule.

Even if the decision in *U. S. v. Community Services, Inc.,* 189 F.(2d) 421 (C.A. 4th), were thought to be correct (and we think it incorrect), petitioner would still be exempt. That decision holds that the 1950 amendments to §101(6) indicate legislative construction of §101(6) as not exempting organizations whose primary purpose was operation of a business enterprise. Petitioner, however, had no primary purpose of operating a business enterprise. The original contribution to petitioner consisted solely of securities, and the policy of petitioner's trustees was to invest in real estate and securities. The Savoy Hotel building was purchased as a real estate investment. Petitioner's trustees did not wish to operate the hotel and made efforts, finally successfully, to find a lessee. The three small candy shops, the investment in which was *de minimis,* were acquired as a means whereby the volunteer, uncompensated services of one of the grantors could be devoted to raising money for charity. The provisions and legislative history of the 1950 Act show that Congress not only understood but also continued to provide that I.R.C. §101(6) applied even though the organization was conducting

a business enterprise, where the enterprise was not the primary purpose of the organization.

Were petitioner not exempt under §101(6), still no tax would be due because petitioner would be entitled to deduct its entire net income under I.R.C. §162(a). The statutes, legislative history, regulations and decisions all are in accord to the effect that income earned and retained by an irrevocable trust for exempt organizations is permanently set aside during the taxable year and is deductible under the first clause of §162(a), even though not paid out to and not credited to any particular beneficiary during the year, and even though it is used to discharge corpus obligations or otherwise will be subject to the risks of investment. This deduction depends on the provisions of the trust instrument, not on any particular action of the trustees thereunder. Petitioner is also entitled to deduction of all of its net income under the second clause of §162(a) which contains no reference to setting aside during the taxable year, but permits deduction of any income to be used exclusively for exempt purposes. The decision below granting deduction under I.R.C. §23(o) to individuals contributing to petitioner is inconsistent with the denial of deduction to petitioner under §162(a).

Furthermore, the assessments for 1943, 1944 and 1945 are barred by the statute of limitations contained in I.R.C. §275(a). The returns on Form 990, pursuant to I.R.C. §54(f), were sufficient to start the running of the statute because they were returns filed under the provisions of the income tax law in good faith as the appropriate return thereunder, and they disclosed all

data necessary for assessment of any tax due. Any other result would deprive an organization, which in good faith is believed to be exempt, of the benefit of the statute of limitations.

ARGUMENT

I.

OPERATION OF HOTEL AND CANDY SHOPS DID NOT DEPRIVE PETITIONER OF EXEMPTION UNDER I.R.C. §101(6)

Exemption from tax under I.R.C. §101(6) (Appendix, *infra*, p. 69) was denied to petitioner by the Tax Court solely for the reason that, during the years involved, petitioner operated a hotel and candy shops. Operation of these enterprises, the Tax Court held, gave petitioner a purpose of making money which, in that court's view, meant that petitioner was not organized and operated "exclusively" for charitable purposes within the meaning of I.R.C. §101(6), even though the court held petitioner to be a valid, charitable trust, all the corpus and income of which was irrevocably required to go to charitable organizations.

A.

THIS COURT HAS INDICATED APPROVAL OF GENERAL RULE THAT DESTINATION, NOT SOURCE, OF INCOME CONTROLS IN DETERMINING EXEMPTION

This same issue, but involving charitable corporations rather than trusts,[1] has been the subject of considerable

[1] Both corporations and trusts are covered by the same language in I.R.C. §101(6). *Fifth-Third Union Trust Co. v. Commissioner*, 56 F.(2d) 767 (C.C.A. 6th).

recent litigation since the Tax Court in *C. F. Mueller Co.,* 14 T.C. 922, decided not to follow the previously generally accepted rule that the ultimate destination of the income controlled in determining exemption. The Fourth Circuit held to the same effect in *U. S. v. Community Services, Inc.,* 189 F.(2d) 421 (C.A. 4th). Nevertheless, the Third Circuit in *C. F. Mueller Co. v. Commissioner,* 190 F.(2d) 120 (C.A. 3d), reversed the Tax Court decision.

The problem raised by this position of the Fourth Circuit and Tax Court has already been considered by this court in *Squire v. Students Book Corp.,* 191 F.(2d) 1018 (C.A. 9th). There a business corporation, the stock of which was wholly owned by the Regents of a state university in trust for a tax exempt student's organization, operated a book store and restaurant on the campus. This court held the corporation to be exempt even though receiving income from business operations.

While it cannot be said that the *Students Book Corp.* case is precisely identical with that at bar, we believe it is determinative of the issue here. The difference between that case and this lies in the fact that the book store and restaurant which were operated by the Students Book Corporation bore, in the words of this court (191 F.(2d) at p. 1020), "a close and intimate relationship to the functioning of the college itself". Here, the hotel and candy shops bore no immediate relationship to the charitable objectives of the Trust. Nevertheless, it appears from the opinion in the *Students Book Corp.* case that the relationship of the business activity to the college was regarded as an additional reason for the ex-

emption rather than the turning point on which exemption was granted.

In the *Students Book Corp.* opinion, this court said (191 F.(2d) at p. 1020):

> Since the decision of the second circuit in *Roche's Beach, Inc. v. Commissioner,* 2 Cir., 96 F.(2d) 776, most of the circuits confronted with the problem appear to have applied the 'ultimate destination' test in determining whether the profits of a commercial enterprise are exempt under §101(6), or, to put the matter another way, if the only purpose of the enterprise is to devote its profits to charitable or educational ends the exemption has been usually held to attach. It has been thought that the exemption, unlike exemption statutes generally, should be liberally construed because of the gain to the public through the encouragement of charity. In two very recent decisions, reaching opposite conclusions, namely, *United States v. Community Services,* 4 Cir., 189 F.(2d) 421, and *C. F. Mueller Co. v. C. I. R.,* 3 Cir., 190 F.(2d) 120, the subject has been extensively reviewed and the authorities cited and discussed. We think it unnecessary again to plow this field, more particularly since Congress in the Revenue Act of 1950 has declared a different rule applicable for taxable years commencing after December 31, 1950.

In a footnote, this court then quotes the new provision in the 1950 Act which denies exemption to organizations operated for the primary purpose of carrying on a trade or business, but points out that Congress was careful to say that this provision should have no retroactive effect. Then in the body of the opinion, this court states that it has made no definite pronouncement

on the subject, although *Smyth v. California State Automobile Assn.,* 175 F.(2d) 752 (C.A. 9th), mentions with seeming approval some of the cases holding that it is the purpose to which the income is devoted which determines whether the exemption exists.

This court then states (191 F.(2d) at p. 1020):

> Resolution of the case before us does not depend wholly on the ultimate destination of the taxpayer's profits.

The opinion then goes on to discuss the relationship of the business activity to the college.

Taking the opinion in the *Students Book Corp.* in its entirety, we think it fairly can be said that, while it does not constitute a definite pronouncement that the ultimate destination of the income alone determines exemption, nevertheless it does reflect this court's opinion that ultimate charitable destination of the income is persuasive of exemption and that this court is inclined to follow the test of exemption which was settled until the Tax Court attempted to change it in its decision in *C. F. Mueller Co.,* 14 T.C. 922.

After this court's decision in the *Students Book Corp. case,* the Court of Claims decided *Sico Co. v. U. S.,* 102 F. Supp. 197. The corporation there involved carried on a business of distributing petroleum products. The income was held for the benefit of the public schools. The Court of Claims held the corporation to be exempt on the ground that the destination, not the source, of the funds controlled, following the decision of the Third Circuit in *C. F. Mueller Co. v. Commissioner,* 190 F.(2d) 120, and refusing to follow the decision of the Fourth Circuit in *U. S. v. Community*

Services, Inc., 189 F.(2d) 421. Thus, there is today even further support for the view indicated by this court in the *Students Book Corp.* case.

Two other cases in which the Tax Court applied its view that the destination test should be abandoned are now on appeal. *Donor Realty Corp.,* 17 T.C. 899, is befor the Second Circuit and *American Association of Engineers Employment, Inc.,* P-H Memo T.C. par. 52,062, is before the Seventh Circuit. Attempt by the taxpayer in *U. S. v. Community Services, Inc.* to bring the matter before the Supreme Court was met by a memorandum for the Government stating that the 1950 legislation had made the question completely academic after 1950, and partly academic before that time and that review could serve only to resolve the question in a narrow class of cases. Certiorari was denied. *Community Services, Inc. v. U. S.,* 342 U.S. 932, rehearing denied, 343 U. S. 911.

This brief will not be extended by a resume of the reasons for the adoption of the rule that exemption under I.R.C. §101(6) is determined by the destination of the income, nor by a review of the long line of cases supporting it.[2]. The Third Circuit in *C. F. Mueller Co.*

[2] However, it is interesting to note that every case in which operation of a business has been thought to destroy the exemption of a charitable organization, up to the decision of the Tax Court in this case, was one involving a corporation, not a trust. The only decision involving this issue in connection with a trust, namely *Commissioner v. Orton,* 173 F.(2d) 483 (C.A. 6th), held that operation of a business enterprise did not take away the exemption granted by §101(6). In the case of an irrevocable, charitable trust, factors such as the certainty of devotion of the proceeds to

v. Commissioner, 190 F.(2d) 120 has covered this matter extensively, as has also the Court of Claims in *Sico Co. v. U. S.,* 102 F. Supp. 197, and this court is familiar with this background, as is shown by the opinion in *Squire v. Students Book Corp.,* 191 F.(2d) 1018. We submit that under these decisions, petitioner in this case is exempt from tax by reason of I.R.C. §101(6).

B.

PETITIONER WAS NOT ORGANIZED OR OPERATED FOR PRIMARY PURPOSE OF CONDUCTING A BUSINESS, AND THIS DISTINGUISHES *COMMUNITY SERVICES, INC.,* DECISION

In addition, we wish to point out that the situation at bar is distinguishable from that involved in *U. S. v. Community Services, Inc.,* 189 F.(2d) 421 (C.A. 4th), and petitioner is properly to be held exempt under I.R.C. §101(6) even if the Fourth Circuit were correct in that decision.

The corporate charter of *Community Services, Inc.,* and the facts surrounding its organization established that it was organized to take over and operate a business then being conducted by a private corporation, namely, a canteen refreshment service and retail sales of coal and ice. While the income was to go to charity,

---

the charitable objectives (as compared to a corporation, particularly a business corporation whose exemption is based on charter provisions which might be amended, and the stock transferred to a non-charitable purchaser), the control of the courts over the administration of the trust, and the fiduciary capacity of the trustees, all make it particularly inappropriate to hold that the exemption of a trust was destroyed by business activities.

there is no doubt that the corporation was to obtain that income from the conduct of a particular business enterprise previously conducted by the founder of the corporation. It can be said, therefore, that the basic purpose of that corporation at the time of its organization was to operate a particular business enterprise on behalf of charity.

From the *Community Services, Inc.* opinion, it is clear that by reason of these facts, the Fourth Circuit concluded that a primary purpose of the corporation was to operate a particular business enterprise, and this conclusion led to its holding that the corporation was not organized exclusively for charitable purposes. The court relied strongly on the provisions of the Revenue Act of 1950 (Pub. Law 814, 81st Cong., 2d Sess.) adding to I.R.C. §101 the following language:

> An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation.

While this amendment was not effective during the tax years involved in the *Community Services* case (and was not effective during the tax years involved at bar), nevertheless, the Fourth Circuit felt that it was declarative of, rather than a change of, existing law and could be resorted to in interpretation of the meaning of §101(6) as it existed prior to 1950. See 189 F.(2d) at p. 427. That court thus concluded that §101(6) had never exempted organizations whose primary purpose was to operate a business enterprise and held *Community Services, Inc.* to be taxable.

In the case at bar, the findings of fact show no such primary purpose (nor even any material purpose) of operating business enterprises. The findings show that the original contribution to petitioner consisted entirely of securities, a traditional form of charitable trust investment, and these securities were not sold but remained as a permanent investment of petitioner. (R. 110.) This fact negates the existence at the time of creation of petitioner of any definite purpose of operating business enterprises. Later contributions to petitioner made by Mr. and Mrs. John Danz and others were all in cash or securities. (R. 112.) At no time was any business enterprise donated to petitioner, nor was any business enterprise of the founders or any other party connected with petitioner ever sold or conveyed to petitioner. Nor were there any strings attached to the gifts of cash and securities made to petitioner whereby petitioner was required to invest in or operate any business enterprise. Petitioner's trustees were entirely free to follow any investment policy they thought best. In considering whether there was a "primary purpose of carrying on a trade or business for profit", there is a marked difference between a case where an organization is created to operate a particular business enterprise and one where the directors of a charitable corporation or the trustees of a charitable trust were given funds with no strings attached on how they were to be invested, and where the funds could be invested in any way that the directors or trustees believed might be to the best interests of the charitable beneficiaries.

The Tax Court found that petitioner was created "for the purpose of making and supplying money" for

charitable organizations. (R. 110.) This finding is entirely consistent with a purpose of making the money through investment rather than through operation of business enterprises. The findings also point out that the Trust Agreement gave broad investment powers to the trustees, including power to conduct business enterprises. However, this is a common provision in creating a substantial charitable foundation in order to meet any contingency that might arise, and does not, of itself, establish that petitioner had as its primary purpose or even as any definite purpose, the operation of business enterprises.

The findings show that the policy decided on by the trustees of petitioner was to invest in improved downtown real estate and in common stocks. All the major investments made by petitioner followed this policy. The improved real estate investments through 1947 totaled $422,838.15. The common stock purchases through 1947 totaled $178,845.89. (R. 113-114.) These are traditional types of charitable foundation investment and they do not indicate any purpose, much less a primary purpose, of operating business enterprises.

The particular activities relied on in the Tax Court opinion to bring this case under the *Community Services, Inc.* decision were the operation of the Savoy Hotel and the candy shops. Regarding the Savoy Hotel, however, the Tax Court expressly found that the intention of petitioner's trustees was to operate the hotel only until the personal property could be sold and the real property leased to a hotel operator. The Tax Court further found that efforts were made to find such a lessee but no satisfactory arrangement was made until

January 1, 1948, when the furnishings were sold and the real estate leased. Moreover, the findings point out that petitioner did not operate the hotel directly during the years 1943 through 1947 but had a real estate company, which was operating the hotel when the building was acquired by petitioner, continue to operate the hotel for petitioner until the lessee was found. (R. 116-117.)

Regarding the candy shops, the Tax Court's findings are to the effect that Jessie Danz, one of the founders of petitioner, managed the candy shops without compensation because she wanted to make a contribution in that way to the acquisition of funds for the charitable trust. (R. 115.) Furthermore, the Tax Court's findings show that petitioner's investment in these shops was insignificant in light of its other investments. These candy shops were purchased for $3,889.75, in comparison to investments in real estate and stocks totaling $601,684.04.

We submit that when all of the Tax Court's findings of fact are considered, they not only fail to establish that petitioner was organized and operated for the primary purpose of operating business enterprises, but also they affirmatively establish that the operation of business enterprises was not even a material purpose of petitioner. The purpose of acquisition of the Savoy Hotel building was that of a real estate investment. Petitioner, at the time of acquisition of the building and at all times thereafter, desired *not* to engage in the hotel business and made continuing efforts to find a tenant-operator with eventual success. The purpose of acquiring the three little candy shops was so that Jessie Danz, one of the founders of petitioner, could

devote her volunteer services toward assisting the charitable objectives of petitioner. Use of small candy shops for this purpose is commonplace among charitable organizations. Moreover, it is *de minimis* as far as petitioner was concerned, the investment in these candy shops being only about six-tenths of one per cent of the total investments made by petitioner during the taxable years. Actually, a large part of the $52,650.44 net profit earned by petitioner in the period 1943 through 1947 from these candy shops should be treated as a donation from Mrs. Danz, rather than as net profit earned from the conduct of a business enterprise, when one considers the reasonable value of Mrs. Danz' donated services for four and one-half years in managing these shops.

Every case with which we are familiar previous to that at bar, where it has been held that operation of a business enterprise destroys the exemption, has been a case where a corporation was organized for the purpose of taking over a particular existing business. In *C. F. Mueller Co. v. Commissioner,* 14 T.C. 922, it was a macaroni manufacturing business; in *Joseph B. Eastman Corp.,* 16 T.C. 1502, it was an automotive parts and service business; in *Donor Realty Corp.,* 17 T.C. 899, a realty business; and in *American Association of Engineers Employment, Inc.,* P-H Memo T.C. par. 52,062, an employment agency. These cases all may be said to bear resemblance to *Community Services, Inc.* in that the primary purpose on creation of the corporation was to take over and operate a particular business enterprise.

The importance of the distinction between charitable

organizations having as the primary purpose the operation of some business enterprise, and a charitable organization such as petitioner, which, although it happened to be operating business enterprises in the particular years here in question, did not have as its primary purpose the operation of business enterprises, appears when one considers the Revenue Act of 1950 which was relied upon by the Fourth Circuit in the *Community Services, Inc.* decision as showing legislative interpretation of the previous meaning of I.R.C. §101(6). The amendments made by the 1950 Act deprived a feeder charitable trust or corporation of the benefit of §101(6), for years after 1950, if it were operated for the primary purpose of carrying on a trade or business for profit. However, these same amendments made it clear that §101(6) still included an organization, even though it operated a trade or business, as long as the operation of that business was not the primary purpose of the organization.

Section 301(b) of the Revenue Act of 1950 (64 Stat. 906) amended I.R.C. §101 by adding at the end thereof the following paragraph:

> An organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt under any paragraph of this section on the ground that all of its profits are payable to one or more organizations exempt under this section from taxation. For the purposes of this paragraph the term "trade or business" shall not include the rental by an organization of its real property (including personal property leased with the real property).

Section 301(c) of the same Act added to I.R.C. §101 another paragraph to follow the one just quoted. This second addition reads:

> Notwithstanding supplement U, an organization described in this section (other than in the preceding paragraph) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

Supplement U provides that in the case of certain exempt organizations having unrelated business income, the unrelated business income itself shall be taxable but the balance of the income of the exempt organization is not taxable. I.R.C. §§421-423, as added by the Revenue Act of 1950, §301(a). Supplement U is applicable only with respect to taxable years beginning after December 31, 1950. Revenue Act of 1950, §303. Unrelated business income is defined to mean income from a business the conduct of which is unrelated, aside from use of the income, to the exempt purposes of the organization. I.R.C. §422(b) as added by Revenue Act of 1950, §301.

It should be noticed that the language of subsection (6), I.R.C. §101, was not changed by the 1950 Act. If a charitable organization is within the application of §101(6) for years after 1950 even though it conducts business enterprises (as it clearly is under the above provisions as long as the conduct of the business is not the primary purpose of the organization) then Congress must have understood that the language of §101(6) as it existed prior to the 1950 Act was sufficient

to bring within its scope an organization that had business income.

By I.R.C. Supplement U, added by the 1950 Act, Congress imposed an income tax on that part of the income of exempt organizations which was derived from conduct of certain business operations. Supplement U applies, after 1950, to exempt organizations having business income where the operation of the business is not the primary purpose of the organization. Where operation of a business is the primary purpose of an organization, Supplement U does not apply because that organization is not exempt under I.R.C. §101, and is taxed on its entire income under the ordinary taxing provisions of the income tax act. Supplement U was a new tax on organizations regarded as exempt. Supplement U presupposes that the organization it applies to is exempt and that the income it taxes would be non-taxable were it not for the special tax imposed by Supplement U itself.

This quite evident meaning of the amendments made by the 1950 Act is confirmed by the committee reports on that Act. H. Rep. No. 2319, 81st Cong., 2d Sess., states in part III(e)(1):

> Your committee's bill imposes the regular corporate income tax on certain tax-exempt organizations which are in the nature of corporations and the individual income tax on tax-exempt trusts with respect to so much of their income as arises from active business enterprises which are unrelated to the exempt purposes of the organizations.
>
> Your committee's bill does not deny the exemption where the organizations are carrying on unrelated active business enterprises or require that they dispose of such businesses but merely imposes

> the same tax on income derived therefrom as is borne by their competitors.

S. Rep. No. 2375, 81st Cong., 2d Sess., states in Part VIII(A)(1) regarding Supplement U of the bill (U. S. Code Cong. Serv. 1950, Vol. 2, p. 3081):

> In neither the house bill nor your committee's bill does this provision deny the exemption where the organizations are carrying on unrelated active enterprises, nor require that they dispose of such businesses. Both provisions merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors. In fact, it is not intended that the tax imposed on unrelated business income will have any effect on the tax-exempt status of any organization. An organization which is exempt prior to the enactment of this bill, if continuing the same activities, would still be exempt after this bill becomes law. In a similar manner any reasons for denying exemption prior to enactment of this bill would continue to justify denial of exemption after the bill's passage.

Both from the Revenue Act of 1950 and from its legislative history, it is evident, then, that Congress regarded I.R.C. §101(6) as granting exemption to an organization even though it conducted a trade or business. The 1950 Act expressly denied the exemption for future years in situations where the conduct of the business was the primary purpose of the organization. Whether this denial was a change in the meaning of I.R.C. §101, or merely declaratory of the meaning of that section as it had existed prior to 1950, is a point of dispute between the Third Circuit in *C. F. Mueller Co. v. Commissioner,* 190 F.(2d) 120, and the Fourth Circuit in *U. S. v. Community Services, Inc.,* 189 F.(2d) 421. We

believe that the Third Circuit's view that this denial was a change in the scope of §101 is correct. Nevertheless, if we take the Fourth Circuit's view that the 1950 Act is declaratory of the previous meaning of the section, the clear interpretation of §101 by the 1950 Act is that the operation of a business enterprise does not prevent an organization from being exempt under I.R.C. §101(6) unless the conduct of the business enterprise is the primary purpose of the organization.

The Tax Court's findings of fact establish that the operation of a business enterprise was not the primary purpose of petitioner. Consequently, petitioner is exempt from tax even assuming that the case of *U. S. v. Community Services, Inc.*, 189 F.(2d)421 (C.A. 4th), was correctly decided.[3]

II.

PETITIONER IS ENTITLED TO DEDUCTION OF ALL ITS NET INCOME UNDER I.R.C. §162(a)

Even if petitioner were not itself a tax exempt organization, nevertheless, no tax was due from it because it was entitled to a deduction under I.R.C. §162(a), (Appendix, *infra*, p. 69), for all income permanently set aside for, or to be used exclusively for, exempt organizations. Since petitioner is an irrevocable charitable trust, all of its net income is so held and is deductible.

Without citing any case which supports its position

[3] Space will not be taken here to develop the additional distinction set forth in footnote 8 of the opinion in *C. F. Mueller Co. v. Commissioner,* 190 F.(2d) 120, (C.A.3d), which we believe is sound and on which we also rely.

(because there was no such case), the Tax Court denied the deduction on the ground that petitioner had not paid out to exempt organizations in each year the full amount earned in that year, there being no requirement in the trust instrument that it do so, and the unexpended balance was invested or used to pay off loans and interest thereon. The loans consisted of mortgages or money borrowed on trustees' notes incurred in connection with the making of the investments of petitioner, and the interest was paid on these loans.[4] (R. 94-98, 99-100, 114-115.) The Tax Court stated that the entire income in any year could be invested or put back into any business enterprise carried on by petitioner, and concluded that the income for any particular year used for such purposes might never go to any charity because it might be lost in a business venture. The court further stated that an annual deduction is not allowed by §162(a) merely because the property of the trust must eventually go to charities. (R. 123-125.)

A.

IRREVOCABLE REQUIREMENT THAT ENTIRE FUND GO TO EXEMPT ORGANIZATIONS SUPPORTS DEDUCTION UNDER EITHER CLAUSE OF §162(a)

Contrary to the statement in the Tax Court opinion, an annual deduction of the entire net income of a trust was authorized by either and both clauses of I.R.C.

---

[4] There is no question presented under §162(a) as to the interest since the interest is independently deductible and the deduction taken on the returns under §162(a) was of the net income after eliminating therefrom the amount paid out as interest.

§162(a), as it read during the years in question, where the trust instrument irrevocably required all corpus and income of the trust to go to exempt organizations.

During the years 1943 through 1947 which are here involved, I.R.C. §162(a) read as follows:

> (a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23(a)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23(o), or is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit.

This section, of course, applies to trusts which are not tax exempt organizations, since tax exempt trusts would need no deduction.

It will be noticed that the language of the section contains two co-ordinate clauses, under either of which deductions may be taken. The first clause covers any part of the gross income which, pursuant to the terms of the trust instrument, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in §23(o). The second clause covers any part of the gross income which, pursuant to the terms of the trust instrument, is to be used exclusively for stated exempt purposes. The deduction contended for by petitioner is, we believe, clearly allowable under the first clause of the section, and we believe, also, that

the deduction is authorized by the second clause of the section. In the opinion of the Tax Court, the first clause only of §162(a) is quoted.

1. Income of petitioner is by the trust instrument permanently set aside for charitable organizations under first clause of §162(a)

As the opinion of the Tax Court recognizes, the trust instrument in this case requires that all of the assets of petitioner, whether corpus or income, be held irrevocably for payment to charitable organizations qualifying under I.R.C. §23(o) (Appendix, *infra,* p. 67). This fact, in and of itself, constitutes a setting aside during the taxable year of all of the income of petitioner and gives petitioner the right to a deduction under the first clause of §162(a).

Several of the cases consolidated in the Tax Court with those at bar involved deductions under I.R.C. §23(o) by contributors to petitioner for the amounts of their contributions. Section 23(o) granted individuals deduction of contributions "to or for the use of" exempt organizations. Appendix, *infra,* p. 67. In its opinion in this case, the Tax Court allowed deduction for contributions to petitioner, holding that the words, "for the use of," conveyed a meaning similar to "in trust for" so that the contributions here made to petitioner —an irrevocable trust for exempt organizations—qualified under §23(o). R. 126. This holding is in accord with long-settled construction. *Schoellkopf v. U. S.,* 124 F. (2d) 982 (C.C.A. 2d); *H. H. Bowman,* 16 B.T.A. 1157 (Acquiescence IX—1 C.B. 6); I. T. 3707, C.B. 1945, p. 114.

The decision of the Tax Court on §162(a) is inconsistent with its decision on §23(o). The first clause of §162(a) grants a deduction to a trust of income "permanently set aside for the purposes and in the manner specified in §23(o)." Under the trust instrument here involved, the income received by petitioner was held for exactly the same purposes and in exactly the same manner as were donations received by petitioner. That these purposes and this manner were those specified by §23(o) was determined by the Tax Court in granting the deduction under §23(o).

Prior to 1917, the income tax law provided no deductions, either to individuals or to trusts and estates, for charitable contributions. Section 1201(2) of the Revenue Act of 1917 (40 Stat. 300) gave to individuals, and by reference also to trusts and estates, deduction up to 15% of net income for contributions actually made within the year to charitable corporations or associations.

As far as individuals were concerned, §214(a)(11) of the Revenue Act of 1918 (40 Stat. 1057) retained essentially the same provisions (except restricting the deduction to contributions made to corporations, eliminating associations). The 1918 Act, however, adopted a new section dealing with charitable deductions by trusts and estates. Section 219(b) of that Act provided (40 Stat. 1071):

> * * * there shall also be allowed as a deduction (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) any part of the gross income which, pursuant to the terms of the

> will or deed creating the trust, is during the taxable year paid to or permanently set aside for the United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, or any corporation organized and operated exclusively for religious, charitable, scientific or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; * * *.

Attention is called to the following significant provisions of that section:

First, the new deduction is expressly stated to be a substitute for the deduction allowed individuals which had previously applied to trusts and estates.

Second, the new deduction is unlimited in amount as compared to a limit of 15% of net income imposed on individuals and previously imposed on trusts and estates.

Third, a trust or estate is entitled to a deduction for amounts permanently set aside for charitable corporations, whereas individuals were limited (as were trusts and estates under previous law) to deduction of amounts paid out.

Fourth, in order to secure deduction of amounts paid out during the year, the trust or estate must have paid the amounts directly to a charitable corporation and could not get a deduction for amounts paid to another charitable trust. The same was true of deductions claimed by individuals under §214(a)(11).

It is also significant in determining the construction of this section that the committee report makes no men-

tion of the phrase "during the taxable year." House Conf. Rep. No. 1037, 65th Cong., 3d Sess., p. 52, stated:

> Amendment No. 94. This amendment allows, in the case of estates and trusts, a deduction for amounts which, pursuant to the terms of the will or deed creating the trust, are paid to or permanently set aside for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals; and the House recedes with amendments making clerical changes and confining the deductions to amounts contributed to or permanently set aside for governmental purposes or corporations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual.

Considering both the text of the section and the committee report, we believe that the intent of Congress in the case of trusts and estates was not only to eliminate the 15% restriction but also to eliminate the requirement that in order to get a deduction, the money must be paid out during the year where the will or trust instrument as it existed during the taxable year required that the income be held for and eventually paid to a charitable corporation.

The Revenue Act of 1921 (42 Stat. 227, 246) also made significant changes. Section 219(b) of that Act provided:

> * * * except that (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) there shall also be allowed as a deduction, without limitation, any part of the gross income

> which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of section 214.

Here for the first time is found the reference to the "purposes" and the "manner" specified in the section granting charitable deductions to individuals. Also, the 1921 Act eliminates the word "to" following the phrase, "is during the taxable year paid * * *." The effect of the elimination of the word "to" is to permit deduction of amounts which are paid out during the year but are not paid *to* an exempt organization but are paid *for* such an organization. The most obvious example would be payments to an irrevocable trust for exempt organizations.

S. Rep. No. 275, 67th Cong., 1st Sess., p. 16, states that the amendments found in §219(b) of the 1921 Act were for the purpose of clarifying its provisions and making the interpretation thereof more definite and certain.

The Revenue Act of 1921 also changed the provisions for charitable deductions by individuals. Section 214(a)(11) of that Act added the words, "or for the use of," so that the section read:

> Contributions or gifts made within the taxable year to or for the use of: (A) * * *.

Considering this change along with the simultaneous change made in §219(b) wherein the word "to" was eliminated, it appears that Congress decided that individuals and trusts and estates should all be allowed deductions for contributions made to an irrevocable

trust for exempt organizations. The language so adopted in 1921 continued through the years here involved.

Under this language, if there were in existence another charitable trust identical with petitioner in all respects and if petitioner contributed to this other trust all petitioner's income, petitioner would be entitled to a deduction therefor. This money in the hands of the other identical trust would be subject to all of the risks of being lost through investment or conduct of business enterprises that it is in the hands of petitioner. It would, indeed, be strange if contributions of income to another identical trust were deductible but the same income retained in petitioner's hands was not deductible. In such a case, two identical trusts could be created and each give its income to the other and each thereby secure a deduction for its entire income, but neither could secure any deduction if it retained its own income. The decision below, in effect, reaches this odd result by allowing deduction of contributions to petitioner but disallowing deduction of petitioner's income retained by it.

Congress carefully avoided this result by the provision of §162(a) that a trust may deduct any part of its income which, pursuant to the terms of the will or deed creating the trust, is permanently set aside for the purposes and in the manner specified in the section allowing deduction to individuals for contributions to charity. One of the obvious purposes of this provision is to permit a trust to take a deduction for its retained income where contributions by individuals to the trust to be retained by the trust under the same provisions would entitle the individuals to a deduction.

The fact that the income of a trust is held as a part of the corpus and reinvested, and the fact that no action is taken by the trustees during the taxable year to pay the income to any particular charitable beneficiary, have been held, by rulings of the Bureau of Internal Revenue from the beginning, not to prevent a deduction under the first clause of §162(a) where the deed of trust or the will required all of the assets eventually to go to charitable organizations.

G.C.M. 423 (V-2 C.B. p. 53) involved a trust created by a will where the will left the residue of the property to the trustee, directing the trustee to hold the property with power of sale, investment and reinvestment at its discretion, and to pay over the net income thereof to a certain hospital. The question presented for ruling was whether income arising from gain on sale of part of the assets constituting the corpus was deductible under §219(b)(1) of the Revenue Act of 1926, a predecessor of I.R.C. §162(a). Since there was no direction in the will as to any time when the corpus itself of the trust was to be turned over to the charity and since gain on the sale of assets constituting the corpus is in itself regarded as corpus, there was no clear showing that the income which represented this gain actually in itself would go to the exempt beneficiary. Nevertheless, the Bureau held that a deduction was proper under §219(b)(1), stating that where the trust involves no intermediate estate and remainder over, and is, as this one was, a perpetual charitable trust, the gain on the sale of the corpus becomes a part of the corpus of the fund to be held in perpetuity subject to the terms and conditions of the instrument creating the trust. The

opinion further held that since all the income from this trust was to go to the hospital, the corpus of the fund was permanently set aside for the charity.

If capital gain constituting part of the corpus of a trust is permanently set aside for charity and deductible under §162(a), even though it is a perpetual trust and there is no provision that this gain itself will ever be paid to a charity, then certainly in the case of the Danz trust where the corpus as well as all the income must, within a time specifically provided for in the trust instrument, be paid to charity, a deduction of the income is proper. G.C.M. 423 is a direct holding by the Bureau that income is permanently set aside for a charity and deductible under the first clause of the statute where it is to be held for the eventual benefit of a charity even though it will be subject to the hazards of investment and reinvestment by the trustees.

G.C.M. 423 has never been revoked or modified by the Bureau and was cited with approval in G.C.M. 10423 (XI-2 C.B. p. 127) where the will put the residue of the estate in trust, the income to be paid to the wife during life, with the remainder over to charitable institutions. The question was whether profit from the sale of securities was allowable as a deduction under §162(a). The court held that this profit became a part of the corpus and thus was not available to the life tenant. Since the gain could not be paid to the life tenant, but would be held until the termination of the trust, at which time it would be paid to the charitable institutions, the Bureau held that it was deductible under §162(a). Again, we point out that this capital gain, becoming part of the corpus, could be invested or put back into any business

carried on by the trust. Still, the Bureau held that it was deductible under §162(a), and any possibility that the fund might be lost by bad investments made no difference.

In S. M. 4644 (V-1 C.B. p. 277) a testamentary trust was created with stock of a real estate corporation, and it was provided that the income was to go to private individuals, and upon their death the corpus was to go to charity. The Solicitor held that capital gains became a part of the corpus and thus were by the trust instrument permanently set aside for charity and deductible under §219(b) of the Revenue Act of 1921, which contained only the first clause of I.R.C. §162(a). For all that appears in the opinion, the life tenants would have many years to live and the corpus undoubtedly would be invested and reinvested during that period.

These rulings represent the uniform administrative construction by the Bureau of Internal Revenue of this section of the statute. Until the present case, the court decisions likewise have uniformly construed the first clause of §162(a) as permitting a deduction in situations like that presented here.

This question first arose in *Bowers v. Slocum,* 20 F. (2d) 350, (C.C.A. 2d). There the will of the decedent had left the residue to various charitable organizations. Income was received by this residuary estate during the year 1919, but was not paid to or credited on the books of the estate to any charitable organization during that year. The Commissioner argued that the estate could take no deduction for this income under §219(b) of the Revenue Act of 1918, which contained only the

first clause of what is now §162(a), because it was neither paid nor credited to any organization during the year. The court held, however, that it was deductible as permanently set aside for the charitable organizations, saying (p. 352):

> Section 219(b) does not make the deduction depend upon the action of the executors in crediting the income upon their books, but upon the permanent setting aside of the income by the will itself for corporations of the character in question. The question, therefore, resolves itself into this: Was the income received by the estate during the year 1919 permanently set aside for the residuary legatees by the will itself?

The court also stated (p. 353):

> In the case at bar the testatrix took the most effective method of setting aside the income in question for the residuary legatees, because by the will itself she set aside for them everything that was left, and thus we find that the income, when received by the executors, was by the will permanently set aside for the residuary legatees, the corporations in question, and that the income in question for the year 1919 was deductible under the provisions of section 219(b).

At about the same time as this Second Circuit decision, the same taxpayer and the same issue came before the Board of Tax Appeals, involving the year 1921. *Herbert J. Slocum, et al, Executors,* 6 B.T.A. 36. The board said (p. 40):

> * * * We think it was the intent and purpose of Congress that income of an estate which, in following out the provision of a will, could be shown to be certainly destined for uses specified in para-

> graph (11) of subdivision (a) of section 214 should be allowed as a deduction in computing the net income of the estate, * * *
>
> * * * Subdivision (b) of section 219 does not make the deduction depend upon the crediting or payment but upon the permanent setting aside of the income for charitable, religious, or educational purposes. The will directed that the residuary estate 'wheresoever and whatsoever' be distributed to the exempt institutions. When the executors received the income it became a part of the residuary estate and was permanently set aside for and belonged to the exempt institutions. It was, therefore, a proper deduction by the estate.

Ever since these two decisions involving the *Slocum Estate,* it has been accepted that deductions under what is now the first clause of I.R.C. §162(a) were in no way dependent upon any action by the executors or the trustees, but any income which, by the terms of the will or the trust, must eventually go to charities was deductible. *E. C. Johnson, Executor,* 13 B.T.A. 850; *Hu L. McClung, et al, Executors,* 13 B.T.A. 335; *E. Schier Welch, et al, Trustees,* 9 B.T.A. 1370; *Irving Bank-Columbia Trust Co.,* 8 B.T.A. 833; *Beggs v. U.S.,* 27 Fed. Supp. 599 (Ct. Cls.).

Considering the provisions of the statute, the committee reports, the rulings and the decisions, we submit that it is settled that the first clause of §162(a) permits a deduction for any income of an estate or trust where the will or deed of trust contains irrevocable provisions that the income must eventually go to charitable organizations. No payment or crediting or other action by the trustees during the taxable year is required, nor

is it necessary that the will or deed of trust direct that any particular action be taken during the taxable year. Furthermore, the deduction is not affected by the fact that the income will be invested and will be subject to the possibility of being lost if the investments of the trust are unsuccesful. We submit that the Tax Court erred in denying petitioner a deduction under the first clause of §162(a) in the amount of its net income.

2. *Deduction of all of the income of petitioner is proper under the second clause of §162(a)*

The deduction taken in the present case by petitioner of all of its net income in each year is not only authorized by the first clause of §162(a), but is also independently authorized by the second clause of that section added in 1924. In fact, the interpretation of the two clauses has been such that they both accomplish the same result in the ordinary case, such as the present case, the second clause accomplishing the additional result of permitting the deduction where the estate or trust itself is to use the money directly for charitable purposes rather than to give it to charitable organizations.

As we have previously mentioned, I.R.C. §162(a) was first adopted as §219(b) of the Revenue Act of 1918 (40 Stat. 1057, 1071), and allowed a trust the deduction of any part of the gross income which, pursuant to the terms of the will or deed creating the trust, was during the taxable year paid to or permanently set aside for charitable organizations. In 1924, this Act was amended by adding a provision that the deduction could likewise be taken as to any income that "is to be used exclusively

for" charitable purposes. Revenue Act of 1924, §219(b) (43 Stat. 253, 275). In adopting this amendment, Congress intended it to permit an independent deduction in addition to that permitted by the language of the first clause of the section, which had been adopted in 1918. S. Rep. No. 398, 68th Cong., 1st Sess., p. 25, states that the 1924 amendment to the section was added, "to permit as an additional deduction that part of the gross income which, pursuant to the terms of the will or deed, is to be used exclusively for the prevention of cruelty to children or animals, since contributions by individuals to organizations for these purposes are deductible under §214(a)(10)." In conference, this language was expanded so that it included the purposes of religious, charitable, educational, etc., which were in accord with the types of organizations set forth in the first clause of this section as adopted in 1918. See the statement of the managers on the part of the House at p. 19, as attached to H. Conf. Report No. 844, 68th Cong., 1st Sess.[5]

The language of the statute itself confirms the statement of the Senate Committee that this amendment was

---

[5] The language of the Senate Committee above quoted indicates further the understanding of Congress that a trust receives a deduction in the amount of its income in situations where contributions to the trust are deductible by the contributing individuals under §214(a)(10), the predecessor of I.R.C. §23(o). This Senate Report thus highlights the inconsistency of the Tax Court in this case in granting deduction under §23(o) to the individuals for contributions made to petitioner and at the same time denying petitioner a deduction of its own income, both the contributions received and the income received by petitioner being held under the same provisions of the trust instrument.

intended to permit an independent deduction. The two co-ordinate clauses of §162(a) both commence with the word "is," and the section has full meaning when read with either of these clauses, omitting the other. Thus, if it is desired, the section can be read as follows (taking the language as it existed during the taxable years here in question):

> (a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by §23(o)) any part of the gross income without limitation which pursuant to the terms of the will or deed creating the trust * * * is to be used exclusively for religious, charitable, literary or educational purposes.

The regulations adopted under the 1924 Act show that the administrative construction was to the same effect. Regs. 65, Art. 342, provided:

> (1) If the terms of the will or of the deed creating the trust direct that any part of the gross income of the estate or trust (a) be paid or permanently set aside for charitable or other purposes as specified in §214(a)(10), or (b) be used exclusively for religious, charitable, scientific, literary or educational purposes * * * such gross income so paid or set aside during the taxable year shall be allowed as a deduction in lieu of the deduction authorized by §214(a)(10).

The language of the regulations under the 1924 Act was used in all the regulations until the 1934 Act. At that time, it was changed to read as follows (Regs. 86, Art. 162-1):

> (1) Any part of the gross income of the estate or trust for its taxable year which, by the terms of the will or of the instrument creating the trust, is

> paid or permanently set aside during such year for the charitable, etc., uses or purposes referred to or described in subsection (a) of section 162.

This change in regulations was undoubtedly, as we will point out, caused by the fact that the interpretation of the section had been such that a deduction under that section would ordinarily qualify under both clauses of the section, and it apparently was not deemed necessary to continue to state the two clauses in the alternative. Notice should be taken of the fact that while the second clause of §162(a) does not include the phrase, "during the taxable year," the 1934 regulations appear to apply this phrase to both clauses. No difficulties flowed from this consolidation because it was generally understood that where income was being accumulated, rather than paid out, the existence of trust provisions requiring a charitable use of the funds was all that was required by the phrase concerning the taxable year.

The language of the 1934 regulations has continued throughout the years involved in this case. See Regs. 111, §29.162-1.

While the second clause of §162(a) was undoubtedly primarily intended by Congress to reach situations where the trust retains its income for eventual direct application by the trust itself to exempt purposes, nevertheless, both the administrative and the judicial construction has been that this clause likewise authorizes a deduction where the income is held for payment to other organizations that will apply it to exempt purposes. In S. M. 4613 (V-1 C.B. p. 71), the trustees were to hold the property and invest it until it had increased to X dollars, and then turn the entire corpus over to a

corporation created for the purpose of making charitable loans. The question was raised by the Income Tax Unit as to whether the trust could take a deduction for income in years prior to the organization of the corporation that was to eventually receive the money. The Solicitor of Internal Revenue in his ruling held that a deduction was permissible, pointing to the addition to the section in the Revenue Act of 1924.

It will be seen from this ruling that the administrative construction of the second clause of §162(a) was the same as the construction of the first clause, namely, that it authorized the deduction of any income which, under the terms of the trust deed, was held in trust irrevocably for a charitable organization. The second clause also covered the additional situation where the money was held for eventual use by the estate or trust itself for charitable purposes. In this identity of the construction of the two clauses can be seen the reason why the alternative statement of the two clauses that was contained in the regulations prior to 1934 was consolidated into one statement in the 1934 regulations, as previously set forth.

The meaning of the second clause of §162(a) was considered at length in the leading case of *Estate of J. B. Whitehead,* 3 T.C. 40, Affd. *sub nom. Commissioner v. Citizens and Southern National Bank,* 147 F.(2d) 977 (C.C.A. 5th). In the *Whitehead* case, the testator left a will providing that a corporation should be formed to take his residuary estate and, after paying certain special bequests to various individuals, pay the balance to charity. The question involved in the case was whether the estate was entitled to take a deduction

under §162(a) for that part of its income which was held for payment to the corporation. The will provided that the corporation would be managed by trustees or directors and that one-fourth of the income should be used by them by disbursing it to the most deserving orphans' home or homes, and the balance should be used for charitable purposes, either directly or given to charitable institutions. The estate borrowed substantial amounts of money, in the neighborhood of $1,000,000.00, for purposes of paying off obligations of the estate, and a good part of the income of the estate was used to make payments on these loans. Although the decedent passed away on November 14, 1935, no distributions were made to the charitable corporation until 1938. The estate claimed a deduction in 1936 for $431,449.53 as income accrued in favor of the charitable corporation. This was the entire income of the estate, less the amount going to the private beneficiary.

The Tax Court held that the test of the propriety of the deduction claimed was furnished by the terms of the will and not by what was actually done thereunder, and referred to the second clause of §162(a), as added by the Revenue Act of 1924, stating that this language provided an additional deduction, and further stating (p. 49):

> Apparently, and it seems to us with good logic, it was considered that the trust involved in the requirement of exclusively charitable, etc., use would guarantee application to such uses equally as safely as requiring an organization formed and operated exclusively for such uses. If, therefore, in this case the will provided that any part of the gross income of his estate was to be used exclusively for

> charitable or educational uses, as to such part the foundation, the agency for such use, provided by the will need not comply with the requirements of the earlier part of §162(a), that is there need be no payment to, or permanent setting aside to, an entity organized and operated exclusively for charitable or educational purposes with no benefit inuring to private individuals, as required by the section prior to 1924.

The Tax Court then referred to §403(a)(3) of the Revenue Act of 1921, allowing a deduction for estate tax purposes of bequests to or for the use of a charitable corporation or to a trustee exclusively for charitable purposes, and referred to *Eagan v. Commissioner,* 43 F.(2d) 881 (C.C.A. 5th), stating (p. 50):

> * * * There is in our opinion no essential difference, so far as here concerned, between the latter part of section 403 construed as above by the court, and the latter part of section 162(a). In the case of each, provision for deduction merely because of exclusively charitable, etc., use of legacies was added to the earlier clause requiring that the recipient be an organization organized and operated exclusively for such charitable, etc., purposes. That the intent was to broaden the deductions beyond those merely to organizations particularly organized and operated is patent. A trust was imposed in the instant case upon the funds to be 'exclusively used' for charity, education, etc. They were received in trust for such use. The respondent, upon reply brief, takes the view that the foundation received the remainder in trust. We conclude and hold that within the 'to be used exclusively' clause in section 162(a) the foundation receiving and disbursing the estate was not required to qualify

> under the earlier language, as one organized and operated exclusively for charitable purposes, etc., but that the statutory provision covers the situation if the charitable, etc., use of the estate as directed by the will was to be exclusive. The use required by the will, not the character of the disbursing agency, is sufficient test, under the latter part of section 162(a).

The Commissioner also resisted the deduction on the ground that the will did not direct the income to be used for charity during the period of administration. On this point, the Tax Court stated (p. 54):

> It is also contended that the deductions claimed are improper for the reason that the will does not direct the income to be used for charity during the period of administration, covering the taxable years, but that only the foundation could, under the will, spend the income upon charity. In *Potter v. Bowers, supra,* the court followed *Bowers v. Slocum, supra,* and held that it was not essential that the charitable institution be in existence during the taxable year, it being sufficient if the will mandatorily required its incorporation, and that the income ultimately distributed was deductible even though it had been reduced by an amount paid to settle a suit contesting the will. Here the will directed the organization of the foundation as soon as possible after the testator's death. Petitioner had no discretion in the matter and was bound by the direction set forth in the will.

The decision of the Tax Court in the *Whitehead* case was affirmed by the Circuit Court of Appeals for the Fifth Circuit in *Commissioner v. Citizens and Southern National Bank,* 147 F.(2d) 977. The Commissioner par-

ticularly argued that the amounts of income which had been paid to discharge debts and obligations of the estate were not deductible under §162(a) because they had not been paid or permanently set aside during the taxable year exclusively for charitable purposes. The Circuit Court of Appeals states (p. 980):

> * * * As to the claim that the use of the income by the executor to defray corpus charges has subjected the charity to taxes on income which the statute expressly exempts from tax, taxpayer, citing cases the Tax Court cites, urges that it is the terms of the will and not what the executor does with the income which determines the exemption, * * *. He argues further that in fact and in law the funds were paid or permanently set over to charitable uses in that, by mere temporary transfer from the income account to the corpus account, they discharged claims against the corpus and saved property itself devised to charity.

The Court of Appeals then states that it agrees with the taxpayer and approves the Tax Court opinion, and says (pp. 980-981):

> * * * Neither are we in any doubt that in creating the foundation and in protecting the corpus against the unforeseen contingencies which arose after death, the executor, by defraying corpus charges out of income, has not deprived the charity of the exemption the will and statute conferred whether the view is taken that the use of the income to pay corpus charges was a charitable use or the view that it was not, but, being unauthorized by the will, it was a diversionary act of the executor without effect. * * * Neither does the fact that part of the income was temporarily diverted to defray corpus charges affect the dedication to charity pro-

vided by the will, or subject the exempt income to tax.

The synthesis in the construction of the two clauses of §162(a) is shown by the case of *Lydia Hopkins,* 13 T.C. 952, where a deduction under §162(a) was sustained on the basis that the trust instrument itself permanently set aside the income for a charitable organization and relying on *Bowers v. Slocum,* 20 F.(2d) 350 (which involved only the first clause of §162(a)), but also citing, in support of the conclusion reached, the *Citizens and Southern National Bank* (*Whitehead*) case which involved the second clause of §162(a). The particular questions we are dealing with here were considered in the *Lydia Hopkins* case under Issue B, Docket No. 12818, beginning at p. 973 of the opinion. The issue was whether a capital gain realized by the trust was permanently set aside for a conceded charitable institution. The principal question was the effect of two private annuities, and the court held that these did not prevent a deduction. The Commissioner then argued that the trustees had not sufficiently acted to set aside the gain, but the court, citing the *Whitehead* case, held that the trustor herself had set the fund aside by the terms of the trust instrument. With regard to the management, investment and use of the income, it is interesting to note that in the *Lydia Hopkins* case the trustee had the power to sell any or all of the corpus, to credit the proceeds to corpus, and to reinvest the proceeds in such property, real or personal, as it might deem fit, without being restricted to investments prescribed or authorized by law as trustee investments. The trustee was also given broad powers of management and

control of the trust property. Among the assets of the trust were several pieces of real estate which the trustees managed, most of which were sold in the years immediately following the taxable years involved. In holding that the income was, by the terms of the trust instrument, permanently set aside for charity, the court in no way discussed the use of the income in the making of investments as bearing on such question. Furthermore, the court held that the possibility under the trust that loans might be made to the grantor did not prevent the deduction. While there were several dissents in the *Lydia Hopkins* case, these dissents all went to Issue A in the proceedings, and aparently there was unanimous agreement in the Tax Court on the disposition of Issue B. The Government's appeal from the *Lydia Hopkins* decision was dismissed by stipulation.

The opinion below cites two cases, *Commissioner v. F. G. Bonfils Trust,* 115 F.(2d) 788, and *Commissioner v. Upjohn's Estate,* 124 F.(2d) 73, which hold that the deduction depends upon consideration of the terms of the deed of trust and which consider the effect of the possibility that the income may be used for the payment of private bequests. These cases support our position and the Tax Court, even though citing them, gave no effect to the rule they and the other cases cited by us lay down, which is that the deduction is allowable where the trust deed requires the entire fund eventually to be used for exempt purposes.

The only other case cited in the opinion of the Tax Court is *Old Colony Trust Co. v. Commissioner,* 301 U.S. 379. However, the *Old Colony Trust* case does not support the opinion below. That case involved the de-

ductibility of payments actually made to charitable organizations during the taxable year by a trust where the trust deed did not require the money to go to charitable organizations, but at the discretion of the trustees could have been paid to private individuals. The court held that it was not necessary to a deduction under §162(a) that the deed definitely direct the charitable contributions which are claimed as deductions and that, where the trustees had discretion as to payment to exempt or non-exempt beneficiaries, the trust was entitled to a deduction for the amount actually paid to exempt beneficiaries. This holding in no way affects the settled law that where the trust instrument requires all corpus and income to go to exempt organizations, a deduction of the entire net income is authorized by §162(a).

This court has recently considered §162(a) in *Estate of Huesman v. Commissioner,* 198 F.(2d) 133 (C.A.9th). Deduction was there claimed of income because the estate saw fit to use this income to satisfy a charitable bequest of a percentage of the residue of the estate. The deduction was denied because the will gave no right to the charity to have its bequest payable out of income. This decision has no bearing on the present case where the trust deed directs all corpus and income to be paid to exempt organizations. Nevertheless, the following statement from the opinion shows this court's awareness of the rule that the test of deduction is to be found in the directions of the will or trust deed (198 F.(2d) at p. 136):

> This negatives the idea that the payment was '* * * pursuant to the terms of the will * * * ' under §162(a).

3. Changes made in 1950 act confirm construction of previous law as granting deduction to petitioner

That the construction of §162(a) in the administrative rulings and cases above cited was fully understood as being the law at the time the changes were made in the taxation of exempt organizations in the 1950 Revenue Act is shown by a study of the provisions of that act. Section 321 of the Revenue Act of 1950 (64 Stat. 906, 954) amended I.R.C. §162(a) by providing that the deduction therein granted would be subject to the provisions of a new subsection (g), which was added to §162. Section 162(g) as added by Revenue Act of 1950, §321, provides: (1) that a trust may not take a deduction after December 31, 1950, under §162(a) for Supplement U Business Income which is made the subject of a special tax on exempt organizations after that time; (2) that where the trust has engaged in prohibited transactions with the grantors or others it will be limited to a deduction of 15% of its net income for taxable years subsequent to notification by the Secretary of the Treasury; and (3) it will be limited to a deduction of 15% of the net income where the income permanently set aside and not paid out during the taxable year is unreasonable in amount or duration in order to carry out the purposes of the trust or is used to a substantial degree for other than charitable purposes or is invested in a manner such as to jeopardize the interest of the beneficiaries.

This language indicates a recognition that in years prior to 1950 a deduction could be taken under §162(a) even if the income came from operation of a business and was not paid out during the taxable year but in-

stead was used for further investment. The 1950 Act limits such deductions only for future years.

H. Rep. No. 2319, 81st Cong., 2d Sess., (part III G), which accompanied the Revenue Act of 1950 as reported to the House, stated with regard to the effect of §162(a) as it stood prior to the 1950 Act:

> Thus, a trust which either distributes or accumulates its income for charitable purposes is, for all practical purposes, exempt from income taxes.

Here is a definite statement by the Ways and Means Committee that it understood that under §162(a) prior to the 1950 Act, a trust was entitled to a deduction if the income was put back into corpus and accumulated for future payment to charitable organizations.

We submit that consideration of the Revenue Act of 1950 and the committee report thereon confirms the fact that petitioner is entitled to a deduction under §162(a) for all of the net income of the trust in the years here involved.

III.

RETURNS ON FORM 990 WERE SUFFICIENT TO START RUNNING OF STATUTE OF LIMITATIONS SO THAT ASSESSMENTS FOR 1943, 1944 AND 1945 ARE BARRED

In the event it were held that petitioner is not exempt from taxation and not entitled to a deduction of all of its net income, we submit that the assessment of deficiencies for the years 1943, 1944 and 1945 is barred by the provisions of I.R.C. §275(a) requiring that income taxes be assessed within three years after the return was filed.

Petitioner filed returns on Form 990 for the calendar years 1943, 1944 and 1945 with the Collector of Internal Revenue on September 19, 1946. (R. 83; Joint Exs. 2B, 3C and 4D.) The deficiency letter for these years was mailed to petitioner on October 14, 1949, more than three years later. The question is thus raised as to whether a return by a trust on Form 990 is sufficient to start the running of the statute of limitations.

Petitioner filed the returns on Form 990 pursuant to the provisions of I.R.C. §54(f) (Appendix, *infra*, pp. 67-70). As it read in the years here involved, §54(f) required an exempt trust to "file an annual return which shall contain or be verified by a written declaration that it is made under the penalties of perjury stating specifically the items of gross income, receipts and disbursements and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner, with the approval of the secretary, may by regulations prescribe, * * *." Revenue Act of 1943 (58 Stat. 21, 36) §117(a).[6]

Section 54(f) required a return by every organization exempt from taxation under §101 with certain exceptions, the exceptions not covering petitioner. Section 54(f) is a part of Part V of subchapter B of c. I of the Internal Revenue Code. Chapter I of the Code imposes the income tax. Part V of subchapter B is that portion of c. I which, together with Supplement D (which is expressly supplementary to Part V), provides for the returns to be made by all taxpayers under c. I. I.R.C.

[6] Revenue Act of 1943, §117(b) made this amendment applicable to tax years beginning after December 31, 1942.

§142, a part of Supplement D and thus a part of Part V, provided during the taxable years that fiduciaries, including trusts, "shall make under oath a return * * * stating specifically the items of gross income thereof and the deductions and credits allowed under this chapter and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner with the approval of the Secretary may by regulations prescribe." I.R.C. 1939 Ed. (53 Stat. 1) §142 as amended by Revenue Act 1940 (54 Stat. 516) §7b; Revenue Act of 1941 (55 Stat. 687) §112b; and Revenue Act of 1942 (56 Stat. 798) §131(c)(2).

The information called for in returns under I.R.C. §142 was substantially the same as under I.R.C. §54(f). Thus we have two sections in the same part of the Internal Revenue Code (the part dealing with returns and payment of income tax) requiring returns containing substantially the same information, one section applying to taxable trusts and the other to exempt trusts.

In view of the location of these two sections under Part V (or Supplement D which is supplementary thereto) dealing with returns and payment of income tax and in view of the substantial identity of their requirements, it would indeed be strange if a return under one of these sections were said to be referred to by the words, "the return," as used in I.R.C. §275(a) and a return under the other section be not referred to by those words. In the years here involved, I.R.C. §275(a) read as follows:

> Sec. 275. Period of limitation upon assessment and collection. Except as provided in section 276—
> (a) General Rule.—The amount of income taxes

> imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period. I.R.C. 1939 Ed. (53 Stat. 1) §275(a).

It is true that the Commissioner prescribed different forms for the returns under these two sections, Form 1041 being required under I.R.C. §142, and Form 990 under I.R.C. §54(f). Nevertheless, the meaning of the words, "the return," as used in I.R.C. §275(a) must be found in the language and structure of the law itself rather than in the acts or requirements of the Commissioner thereunder. Moreover, where the information called for and furnished is substantially the same in both returns, as it is here, the fact that the Commissioner asks for it in a different form or arrangement should not affect the substantive identity of the two returns.

At the time these returns were filed by petitioner on Form 990 on September 19, 1946, there had been no ruling by the Commissioner as to whether or not petitioner was exempt. Compliance with the Internal Revenue Code in the matter of filing returns on behalf of this trust required the trustees to make their own determination as to whether or not the trust was exempt. The trustees in this case believed and still believe that petitioner was and is exempt and, consequently, interpreted Part V of the Internal Revenue Code as requiring that petitioner should file returns under §54(f). Even if the courts were eventually to hold in this case that petitioner is not exempt, there would be no doubt that the

trustees acted in good faith and on reasonable grounds in filing returns under §54(f) rather than under §142. In such circumstances, there is no reason in law or equity why a trust should be deprived of the protection of the statute of limitations.

While we are unable to find any decision involving these two particular types of returns, we believe that the case of *Germantown Trust Co. v. Commissioner,* 309 U.S. 304, 84 L.Ed. 770, is determinative of this matter. In the *Germantown Trust* case, an ordinary trust filed a fiduciary return on Form 1041. The Commissioner later contended that the trust was an association taxable as a corporation. The Commissioner contended that a Form 1041 fiduciary return did not start the running of the statute of limitations on a tax under the corporation provisions of the income tax law. The Supreme Court held that it did, stating that the return on Form 1041 contained all of the data from which a tax could be computed and assessed, although it did not purport to state any amount due as tax. The court pointed out that the fiduciary return was a return of the tax in respect of which the liability arises, namely, the income tax. The court further held that where a fiduciary in good faith made what it deemed the appropriate return which disclosed all of the data from which the tax, treated as one imposed upon an association, could be computed, such a return cannot be deemed to be no return so as to leave the fiduciary unprotected by the statute of limitations.

In the present case, the situation is similar. The fiduciary in good faith made what it deemed to be the ap-

propriate returns. These returns showed in detail all the income and disbursements of petitioner. (Joint Exs. 2B, 3C and 4D.) Thus as in the *Germantown* case, they disclosed all the data from which the tax could be computed if the Commissioner felt that petitioner was taxable rather than exempt. Furthermore, as in the *Germantown* case, the return was filed as a return of the tax in respect of which the liability arises since it was a return required by that part of the Internal Revenue Code providing for the returns which are to be made for income tax purposes. Consequently, the *Germantown Trust* decision is directly applicable.

Decisions such as *Commissioner v. Lane-Wells Co.,* 321 U.S. 219, 88 L.Ed. 684, where the court held that a return filed under the provisions of the income tax law did not start the running of the statute of limitations against the personal holding company tax, are distinguishable because the returns which were filed were not under the Code provisions dealing with the same tax.

The returns on Form 990 here involved were regarded by the Bureau of Internal Revenue as being income tax returns, as is shown by Reg. 111, §29.54-1 (26 C.F.R. 1st Ed. 29.54-1, p. 331) as amended by T.D. 5381, June 26, 1944 (C.B. 1944 p. 188).

The fact that upon request from the Commissioner, petitioner later filed returns on Form 1041 does not destroy the effect of the returns previously filed on Form 990. I.R.C. §54(b) gives the Commissioner the power to require any person to make any return which the Commissioner desires. Certainly by the exercise of this power the Commissioner cannot relieve himself of

the duty to act in the statutory period after a taxpayer has filed a return addressed to the particular tax involved and containing the information from which an assessment of the tax could be made.

Subsequent to the decision of this case by the Tax Court, petitioner's counsel was advised by other attorneys that there had been in effect for some years an unpublished ruling of the Bureau of Internal Revenue holding that returns on Form 990 were sufficient to commence the running of the statute of limitations. Upon inquiry by petitioner's counsel of officials of the Bureau, the existence of such a ruling was confirmed and it was likewise confirmed that the ruling had been followed in disposing of other cases and had not been revoked. Nevertheless, the Bureau refused to supply a copy of the ruling and refused to permit petitioner's counsel to read the ruling.

In this connection, we refer the court to Miscellaneous Report No. 106 of the Farm Credit Administration, United States Department of Agriculture, dated April, 1947, and bearing the title "Preparing Federal Annual Returns for Tax-Exempt Farmers' Cooperatives." This is an official Government publication which was circulated among farmers' cooperatives. It states as follows (p. 4):

> In the case of taxable businesses, the Federal limitations statute bars the Government from making an assessment of taxes after expiration of 3 years from the date of filing an income tax return, except where the latter is fraudulently made.
>
> While an official ruling has not yet been published by the Bureau of Internal Revenue, it is un-

derstood informally that the 3-year period of limitations is started in the case of tax-exempt organizations upon their filing of form 990 provided, of course, that the return is *full and complete.*

CONCLUSION

The Tax Court should be reversed in both cases and as to all years it should be determined that there are no deficiencies, first, because petitioner was exempt under I.R.C. §101(6) and, second, because even if not exempt, petitioner was entitled to a deduction of all of its net income under I.R.C. 162(a). In any event, the decision in Tax Court Cause No. 26404 should be reversed because assessment of deficiencies for the years 1943, 1944 and 1945 was barred by I.R.C. 275(a).

Respectfully submitted,

F. A. LeSourd,
Little, LeSourd, Palmer & Scott,
1510 Hoge Building,
Seattle 4, Washington
Attorneys for Petitioner

Dated: March 31, 1953.

APPENDIX

Statutes Involved

Internal Revenue Code §23(o) as amended by Revenue Act of 1939 (53 Stat. 1) §224:

> *Sec. 23(o) Charitable and other contributions.*—In the case of an individual, contributions or gifts payment of which is made within the taxable year to or for the use of:
>
> * * *
>
> (*2*) A corporation, trust, or community chest, fund, or foundation, created or organized in the United States or in any possession thereof or under the law of the United States or of any State or Territory or of any possession of the United States, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;
>
> * * *

Internal Revenue Code §54(f), as added by Revenue Act of 1943, §117(a):

> *Sec.54(f)* Every organization, except as hereinafter provided, exempt from taxation under section 101 shall file an annual return, which shall contain or be verified by a written declaration that it is made under the penalties of perjury, stating specifically the items of gross income, receipts, and disbursements, and such other information for the purpose of carrying out the provisions of this chapter as the Commissioner, with the approval of

the Secretary, may by regulations prescribe, and shall keep such records, render under oath such statements, make such other returns, and comply with such rules and regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe. No such annual return need be filed under this subsection by any organization exempt from taxation under the provisions of section 101—

(*1*) which is a religious organization exempt under section 101(6); or

(*2*) which is an educational organization exempt under section 101(6), if such organization normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; or

(*3*) which is a charitable organization, or an organization for the prevention of cruelty to children or animals, exempt under section 101(6), if such organization is supported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or is primarily supported by contributions of the general public; or

(*4*) which is an organization exempt under section 101(6), if such organization is operated, supervised, or controlled by or in connection with a religious organization described in paragraph (1); or

(*5*) which is an organization exempt solely under section 101(3); or

(*6*) which is an organization exempt under section 101(15) if such organization is a corporation wholly owned by the United States or any agency

or instrumentality thereof, or a wholly owned subsidiary of such a corporation.

Internal Revenue Code (1939 Ed.) (53 Stat. 1) §101:

Sec. 101. Exemptions from tax on corporations.

The following organizations shall be exempt from taxation under this chapter—

(*6*) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;

* * *

Internal Revenue Code (1939 Ed.) (53 Stat. 1) §162:

Sec. 162. Net income.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(*a*) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23(o)) any part of the gross income, without limitation, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23(o), or is to be used exclusively for religious, charitable, scientific, literary, or educa-

tional purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

* * *

Internal Revenue Code (1939 Ed.) (53 Stat. 1) §275(a):

Sec. 275. Period of limitation upon assessment and collection. Except as provided in section 276—

(*a*) *General rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.